

Can Greece 'grow solvent'?

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The first act of the eurozone debt drama was about whether any European Union member country could ever become insolvent. It ended when the highest EU authority, the European Council, officially recognised in late July that Greece does need a reduction in its debt obligations.

With the completion of the latest rescue package for Greece – which relieved the country of short-term liquidity problems and eased the borrowing terms, but which made only a small dent in the overall debt burden – the question now is whether Greece can 'grow solvent'? Prominent voices (such as Columbia University professor Jeffrey Sachs) have advanced the view that Greece can in fact grow out of the debt crisis provided it can access funding at the same cost as Germany. The argument runs like this: With long-term refinancing of the current debt burden available at a real interest rate of around 2%, and, assuming that real growth rebounds to 3% per year, Greece could work its way back to a manageable debt burden over the next 30 years. A debt-to-GDP ratio of 80% of GDP in 2030 might then become attainable.

This scenario certainly sounds far preferable to a (disorderly) default with potential contagion to other vulnerable euro-area economies. The main problems with the 3% growth scenario, however, are that a) the adjustment process from the bust of a credit-fuelled import boom and the subsequent austerity measures is likely to be prolonged, and b) even if we consider only the very long term, economic growth in Greece faces stiff demographic headwind. In fact, the debt crisis comes at the worst imaginable time concerning the outlook for an important growth ingredient: labour force growth. According to EUROSTAT, 2009 represented the peak of the size of the working age population (individuals between 15 and 64 years old) in Greece (see Figure 1).

Figure 1 shows two projections of the working age population in Greece, one with and one without immigration. Even with substantial immigration, the Greek working age population is now falling and in 2040, it will be close to 10% smaller than it was in 2010. The decline would accelerate significantly if net immigration on a large scale did not materialise. In the absence of immigration, the workforce would decline by 25% over the next 30 years.¹

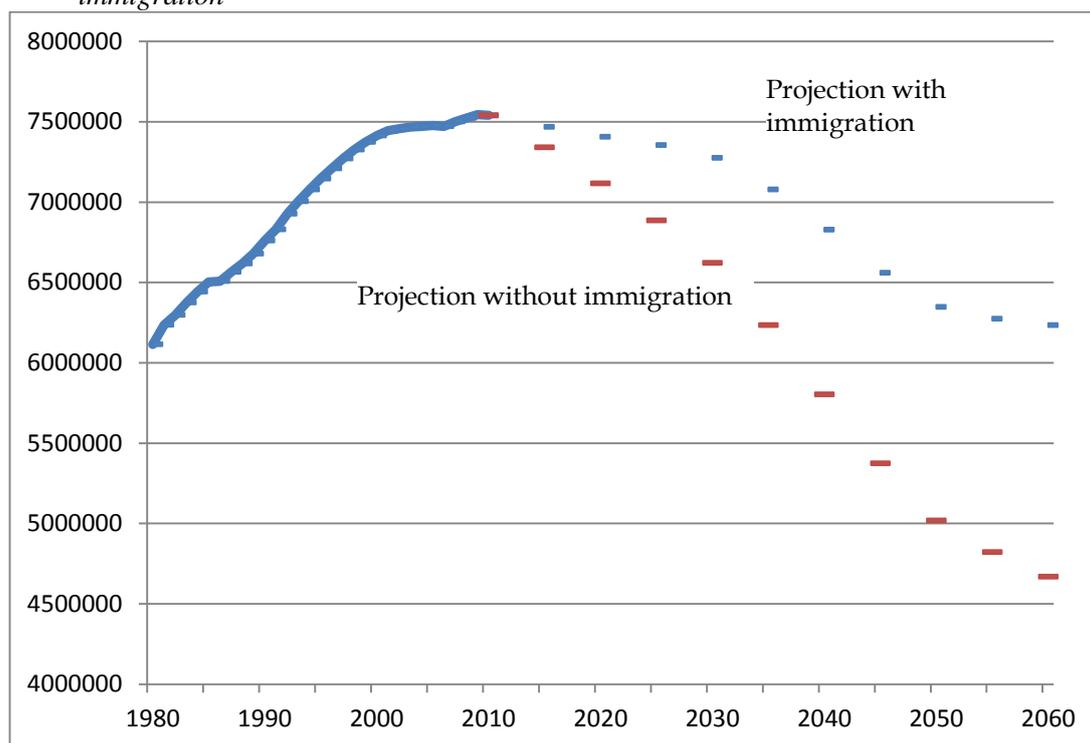
¹ At the same time, a rapid increase in the number of persons aged 65 and above will add to the strain on public finances in the foreseeable future. However, we assume that this has been neutralised by the reforms to the pension system enforced by the adjustment programme of the 'troika'.

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Figure 1. Projections of working age population in Greece (15-64 years) with and without immigration



Source: EUROSTAT, population projection 2010.

It is possible to mitigate the effect of the negative trend in the working age population if a larger share of persons aged 15 to 64 is encouraged to participate in the labour market. Greece is now taking policy measures aimed at increasing the effective labour supply; and, there is some scope for Greece to do just that for some groups of the population, particularly women. However, such structural reforms are likely to come into effect rather slowly. In the long term, an increase in labour market participation by women will add to economic growth; in the short term, the effect on growth of adding individuals who may have been absent from the workforce for years will be limited. Thus, even if Greece were to experience a minor level effect on GDP – as a consequence of adding unskilled workers to the labour force – this will be dwarfed by the shortage of workers available in the coming years.

To appreciate the significance of these projections, note that of the average annual growth rate of close to 3% experienced by the Greek economy from 1970 to 2004, three-quarters of a percentage point came from an increase in labour supply – hours worked – per year (van Ark et al., 2007). The rest (2.25%) was obtained through labour productivity increases. Thus, even a rebound to the pre-crisis level of productivity growth prospects would entail an annual growth rate of only around 2% (2.25% labour productivity growth minus a 0.3-0.9% fall in working age population).² Even supposing that Greece can sustain another 30 years of above-trend labour productivity growth, and, at the same time integrate a sizeable amount of (low-skilled) immigrants into the workforce, the growth scenario is still one full percentage point short on growth. Because large net migration is already an important growth component, it is very hard to imagine policy measures that can result in long-term growth of 3% per year.

In the medium term, the growth story has further complications. During the last decade, Greece's growth was driven almost entirely by the expansion of the non-tradable sectors. That is, domestic services such as retail and wholesale trade (see Table 1). These sectors are likely to suffer for years to come as a result of austerity measures and resulting weak domestic demand and will therefore

² In fact, seen over a 30-year period; this is not far from the Commission's projections of potential growth in Greece (European Commission, 2009).

contribute very little to growth in the medium term (Gros, 2011). This leaves tradables – agriculture and manufacturing – to act as the sole engine of economic growth. This engine, however, has been running in neutral position during the previous decade of strong international growth. Moreover this sector constitutes a relatively small part of the overall economy and is thus unlikely to deliver any significant growth impulse. Alcidi and Gros (2011) characterise Greece as the peculiar case of a “small, closed economy”.

Table 1. Growth of Greek economy by main sectors, 2000-09

	Gross value added, € billion 2000	Real growth, index (year 2000 = 100)	
		2000	2009
Non-tradables - Services, Construction	97	100	140
Tradables - Agriculture, Manufacturing - Raw materials	25	100	105

Source: Eurostat.

Given its unfavourable demographic prospects and the small size of the tradable sector, Greece will face a huge task in growing out of its debt burden. Other well-known issues, such as low competitiveness, inefficient tax collection and a low domestic savings rate only add to the problem, but these issues are – at least in theory – taken care of by the adjustment programme imposed by the EU/IMF/ECB.

With respect to the longer-term demographic development, Greece is admittedly not that different from other troubled eurozone economies. However, for Greece the downturn in the working age population has already begun; it will start later for Spain (2025), Portugal (2022) and Ireland (2040) (European Commission, 2009). This gives these countries some breathing space before demographic pressures set in. Moreover, these other countries have a much larger tradables sector to start with.

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